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# Mortgage Loan Insurance

CMHC'S Approach to

**Mortgage Underwriting  
for Multiple Projects**

Making mortgages more accessible.



CMHC'S Approach to

# **Mortgage Underwriting for Multiple Projects**

April 1997





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# Introduction

**C**MHC is committed to advancing the quality of its products and services through a partnership with its clients. As part of this commitment to partnership, CMHC is pleased to offer this guide which outlines the documentation it needs and the approach it takes when analyzing a request for insurance on multiple unit residential projects. It is hoped that this will facilitate your understanding of our information needs and the reasons for them.

We welcome any comments you may have on this publication. Please address your comments to:

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# Overview

## CMHC

Canada Mortgage and Housing Corporation (CMHC) Mortgage Insurance has been in existence for over fifty years. During that time, it has assisted in the financing of one out of every three housing units in Canada. This extensive experience has provided a unique perspective on risk assessment.

## Purpose of this Document

CMHC has developed this document to explain to lenders or brokers the approach it has developed to underwrite residential projects.

The reader will also know what documents will be required to support an underwriting recommendation and the reasoning behind the requirements.

## CMHC's Risk Assessment

The responsibility for decisions related to risk is entrusted to the underwriter, who carries out the work independently, or with the advice of other professionals, depending on the complexity of the project.

Formal professional reports may be requested from a market analyst, a finance specialist, an appraiser, an architect, a building engineer, an inspector or a property manager. The underwriter correlates the data in each of these specialty areas to arrive at a decision related to the risk.

CMHC aims to structure good loan commitments, and the necessary level of confidence to do this requires an approach that is comprehensive and systematic.

CMHC follows four steps:

- analysis of the housing market
- analysis of the borrower
- analysis of the security
- preparation of an Underwriting Report.

## Contents of this Document

This document describes in detail what is done in each of these four steps and specifies the documentation an underwriter should have to support a recommendation.

Chapters one, two and three describe the analysis of the housing market, the borrower and the security, respectively. Each of these are discussed with reference to these questions:

- What does the term mean?
- Why is it important to analyze this issue?
- How is the report used by CMHC in the risk analysis of a project?
- How does CMHC develop the data?
- What are the components of the reports used in the analysis?

Chapter four indicates the documentation required for an underwriting recommendation, and chapter five describes the underwriting report.



## Part 1

# Analysis of the Housing Market

The term 'market' refers to price, volume and demand regarding housing, and includes any trends, and their fluctuations.

Market factors affect the risk of underwriting mortgage loans.

The underwriter looks to the assessment of the market for answers to risk-related questions like these:

- Is the type of housing marketable in today's market, for example, are the prices or rents too high?
- Are there too many units?
- What is the target group?
- How long will it take to sell or rent-up the project?
- Are local long-term employment and demographic market trends favourable for the type of housing?

The analysis of market data is not a precise statistical or mathematical process utilizing formulas that produce a definite and certain answer. Furthermore, the value of an analysis is limited by the availability and reliability of basic data, and by the accuracy and soundness of judgements incorporated into the analytical process. As a result, a good report will include the market analyst's comments on such matters. In particular it will state the degree of confidence the analyst has in the report's findings, conclusions and advice. The underwriter will take this into consideration during the review of the reports.

Relevant market analysis data is usually obtained from general market reports, done annually or periodically, or from a project report, done for the specific mortgage application.

## Market Reports

A 'market report' is a study of the general conditions of the market. Long-term market reports provide estimates for up to five years and identify basic trends. Short-term reports provide estimates for up to eighteen months and identify most recent fluctuations around the trends. They also evaluate the current market price and volume activity, and their short-term outlook.

These reports identify strong and weak markets, and provide forecasts of housing starts, vacancy rates and changes in prices and rents.

They are useful when performing the preliminary risk assessment of loan applications.

Market reports contain the following:

- a definition of the geographical area of the housing market being studied
- an analysis of its economy and socio-economic structure
- a demographic analysis of the area
- an analysis of the housing stock and of market conditions.

These four are combined to produce an estimate of the housing requirements and housing demand.

## Housing Market Area

The 'housing market area' is the geographic entity in which dwelling units are in mutual competition. Within the area, given the same quality and price, a potential purchaser or tenant is indifferent as to the location, according to economic theory.

Within any housing market area there are submarket areas. These are structural entities in the market area. The degree of precision of the definition of areas is generally in accordance with the purpose of the study and the availability of source data.



Factors to be considered when establishing a market area include:

- transportation facilities and commuting patterns
- natural and political boundaries
- employment centres
- residential development patterns
- locational preferences.

Submarkets are differentiated by qualitative characteristics, such as:

- prices
- rents
- proximity to amenities
- unit types
- sizes.

### **The Economy and the Socio-Economic Structure**

This analysis describes the employment and income potential of the defined market area. It enables changes in population, households and the demand for housing to be estimated. The basis of the report is an economic forecast and an employment forecast.

The economic forecast describes the growth potential for industrial sectors and individual firms, based on a study of the competitive advantages of the area and its economic history.

The employment forecast describes future labour requirements, taking into account the outlook for industry, unemployment rates and participation rates. The employment forecast is used as an internal check for the demographic forecast prepared in the demographic analysis.

### **Demographic Analysis**

This is a study of population characteristics, used to identify the number of households that can reasonably be expected to be formed during the forecast period. Knowing characteristics such as age distribution and the split between family and non-family households permits potential housing requirements by tenure, either rental or ownership, to be determined more precisely.

The analyst reviews studies produced by other agencies, and explains any differences in household and population projections from them. This is critical to the judgement process.

### **Housing Stock and Market Conditions**

This a descriptive summary in data and text of trends in the changes of the housing stock. This analysis provides a perspective on the housing stock and on the market conditions influencing the current housing market for the time period of the study.

Characteristics of the existing housing stock to be studied include:

- conditions
- facilities
- values
- affordability
- adequacy
- suitability.

Current market conditions includes a study of:

- availability and cost of mortgage funds
- arrears
- foreclosures
- land supply and availability
- price of labour and material inputs
- rents and prices of new and existing dwelling units
- the effect of any government programs
- causes, extent and characteristics of vacancies both in ownership and apartments.

## Part 1

Continued

### Housing Requirements and Housing Demand

'Housing requirements' is defined as the number of dwelling units necessary to satisfy the projected household growth, to replace losses in the existing stock and to allow for a reasonable level of vacancies.

'Housing demand' is the number of units of various types and tenure that will be absorbed at their respective price or rents, given the current market conditions. Critical to this estimate is the length of time it will take to absorb the units at the given price or rent.

Annual demand will fluctuate around the long-term housing requirements trend line, as it is subject to changes in the market conditions that affect demand and the interaction with supply criteria. New construction is required when the volume of units supplied at a given price or rent is insufficient to satisfy demand.

Continual monitoring and analysis of the current housing market is necessary in order to predict fluctuations in demand and avoid short-term over supply. If significant events or impacts occur in the market, both the housing requirements and demand estimates may have to be revised.

The housing requirements estimate is presented on an annual basis by type, tenure and sub-market. To create this, the estimates of net household formation, from the demographic analysis, are combined with the estimates of net replacement requirements and the vacancy allowance, from the analysis of housing stock and market conditions.

The estimate of the demand for housing combines the results of the previous four reports. The major determinants of demand are:

- the rate of growth in households
- household income
- patterns of employment
- financial criteria of household choice.

The financial criteria of household choice includes:

- terms
- down payments
- liquid assets
- physical and social conditions, such as taste, suitability and adequacy.

### Project Reports

A 'project report' focuses on the demand for a specific product at a specific location and price during a known future time period. It is an analysis of the micro factors affecting the demand and take-up for the dwelling units related to a specific mortgage-insurance application.

Project reports contain insights into the following main components:

- current supply
- current absorption
- future competition
- future demand
- the marketability of the project.

The answers to these questions are the fundamental outputs of a project report:

- What is out there under construction, recently completed and unoccupied?
- What are the vacancies in the older stock?
- How fast have recent completions been absorbed?
- Have prices gone up, or stabilized?
- What target groups are demanding this type of housing?
- What is coming on the market from other recent or pending approvals?
- Will other alternatives become more attractive?
- Will recent demand trends be maintained, increase or decline?
- Will the forecast employment activity increase or decrease demand?
- Do demographics support higher or lower demand?
- Will this project be absorbed at the proponent's prices or rents?
- How long will absorption take?



## Part 2

# Analysis of the Borrower

There are two main aspects to be examined when analyzing the borrower, competence and capacity.

Analysis of competence involves a study of the:

- track record
- management ability
- quality of the proposed marketing strategy
- relevance of past experience.

Capacity includes a study of both the financial statements and the net worth.

## Competence

### Track Record

Past performance is a leading indicator of a borrower's competence. From a review of the track record it is possible to estimate the borrower's potential for success.

It is likely that a project under consideration would be a success if the borrower has successfully completed or managed a number of similar projects without incident. If, on the other hand, the borrower is entering into a new area, problems may arise from lack of experience. Examples are switching from the construction of single-family homes into a multiple rental project, or purchasing a large multiple project when the past record is only small walk-up buildings.

For this reason, a thorough review of the borrower's activities for the past five to ten years should be included in the report.

Items to be noted in the track record include:

- the number and type of projects built
- relationship with trades and suppliers, in particular whether these have had difficulty in getting paid
- relationship with the bank
- treatment of past projects, such as whether they were sold or retained, and if retained how they were operated.

### Management Ability

A properly managed project has a much better chance of survival even in a depressed market. An analysis of the borrower's management capacity is an essential part of the overall assessment.

Five to seven years of successful management of similar projects has been suggested as the minimum acceptable.

Formal training in property management is helpful but must be supplemented by experience.

A statement on the application that a professional property manager will be hired because the borrower does not have the necessary experience to properly manage a project does not relieve the underwriter from ensuring that the project will be competently managed, because the professional to be hired may not have any more expertise than the borrower.

An assessment of the property management capabilities includes:

- a description of the previous properties managed
- comments on the proposed marketing strategy
- comments on the relevance for the past property management experience.

### Quality of the Proposed Marketing Strategy

Key to the success of a project is a fully rented or fully sold building, and for this, a good marketing strategy is essential.

The marketing strategy should:

- be geared specifically to the proposed clientele and highlight the location and design features that make it attractive to them
- indicate what sort of advertising will be used, when it will start and what level of budget will be required
- detail the monthly expected rate of rent-up or sale during the marketing campaign and the back-up strategies in case of failure
- explain how the physical aspects of the unit will be communicated, such as by model suites or by floor plans only, and why that approach was selected.

### Relevance of Past Experience

An evaluation of the suitability of the previous management experience includes reports on site visits to several of the properties currently managed by the firm and an examination of the management systems used to control the operation of the projects.

Points to be addressed during the site visits include:

- the overall impression regarding maintenance, any evidence of deferred maintenance, and a comment on the condition of the landscaping

## Part 2

Continued

- the quality of tenants, such as turnover, indications of their satisfaction
- the rent levels, with trends and comparison to the market
- the vacancy rates, with trends and comparison to the market.

Points to be evaluated when examining the management systems are:

- procedures for site management
- financial controls system
- personnel practices
- monitoring of income
- monitoring of operating expenses
- tenant selection.

There must be a set schedule for inspecting a property. This would ideally call for a visit to the property once a quarter, but should not be less than once a year.

There should be an adequate accounting system in place for the operation of the building. The system should be able to record receipts from tenants, and indicate from whom, by whom, when and why they were received. A similar system should be in place for disbursements.

There should be a detailed job description for on-site employees, along with a work schedule. Site employees should be hired on the basis of past performance and references from previous employers.

Rent levels should be based on a comparison of market rents for similar projects. The manager should constantly update information on the market. Other sources of income from the project, such as laundry, should also be reviewed to ensure maximum gain.

Operating budgets should be prepared at the beginning of each year and reviewed monthly, to ensure that they are being adhered to. The budget should be based on an analysis of similar buildings and verified with industry averages. Tax assessments and insurance requirements should be reviewed at least once a year to ensure they are reasonable and adequate.

Tenant selection is key to a project's long-term viability. Disruptive and abusive tenants will force out good ones and give the project a bad name, thus discouraging other good

tenants from applying. When faced with increasing vacancy rates, many managers will simply lower their selection criteria, and this can be the beginning of an irreversible downward spiral. Ensure therefore that tenant selection includes a verification of employment history, salary and credit, and that there is a pattern of this process being carried out to consistent standards.

### Capacity

Capacity refers to the borrower's financial ability to absorb losses should unexpected problems arise.

It is essential that the analyst consider the financial requirements of the proposed project in preparing the assessment. For example, if the proposed project will double or triple the proponent's assets, this may indicate that the proponent is trying to grow too fast. Such a borrower is unlikely to have the financial resources to withstand the impact of increased costs or reduced revenues.

In most instances, the financial statements will be for a fiscal year that ended some time ago. Interim financial statements should therefore be requested. These need not necessarily be audited, but should be prepared by an independent accountant.

After examining the balance sheet and income statement, the financial analyst may feel it is prudent to ask for a more detailed breakdown of some items. These may include receivables, costs and revenue.

A review of capacity includes an analysis of the borrower's financial statements and net worth.

The financial statement analysis includes:

- profitability
- source of equity
- liquidity
- interim financing
- deferred taxes
- appraisal surpluses
- credit reports
- bank reports.



The net worth analysis involves:

- stability of value
- liquidity
- ability to realize on assets.

### **Financial Statement Analysis**

This review should include a comment on trends and an explanation of any items that might affect the company's financial health, such as a pending lawsuit.

### **Profitability**

Profitability can be a measure of how well a company is managed as well as an indicator of the potential for the company to remain in business. An essential part of the analysis is to develop trends by considering profitability over several previous years. The proponent will be asked to explain any significant variances from the trend.

### **Source of Equity**

The 'source of equity' is the amount and terms relating to the personal money a borrower has invested in a project.

The financing technique known as leveraging involves acquiring most if not all of the money for a project through borrowing, frequently on a short-term basis. Borrowers use leveraging to the fullest extent possible, sometimes excessively. This can be quite profitable, especially in a rising market with stable interest rates, but can be disastrous in a falling market or when interest rates rise.

The source, amount and terms relating to the equity for the project is therefore important data the underwriter requires to make a risk assessment.

### **Liquidity**

'Liquidity' is a measure of whether a company has sufficient resources to meet its current liabilities.

It is critical that a company has sufficient liquidity to withstand cash-flow fluctuations. In the building and real estate business, a great deal of importance is placed on cash flow. Real estate is a hazardous business with a number of unpredictables that may affect the cash flow, such as strikes, interest-rate hikes and drops in rent levels.

Comments on three things are used by the analyst when assessing liquidity:

- working capital (current assets – current liabilities)
- unused operating lines of credit
- expected results from operations.

Working capital is defined as current assets less current liabilities. Many borrowers often ignore this, which can produce financial difficulties. When short-term cash is used to finance long-term assets, a downturn in construction activity could terminate the cash flow intended to cover the short-term liabilities. A borrower's financial statements may not show current assets and current liabilities. Therefore, the analyst will look at each item in the asset and liability sections of the balance sheet, if necessary, to determine which of the items are current. The analyst also may look at the notes to the financial statements, which frequently show information that is helpful in estimating the current position.

Frequently, borrowers feel that if they have an unused portion of an operating bank line of credit, this, plus their normal sources, will provide them with sufficient cash to meet their day-to-day requirements. There is a certain amount of validity to this, but it should be considered in conjunction with other liquidity information. The amount of bank loans must be determined, as well as the maximum authorized line of credit.

The contribution that the company operations are expected to make to the cash position of the company is also a part of an assessment of liquidity. Two companies with similar liquidity situations before profit and loss from operations is considered may have quite a different liquidity picture if one is expected to make a significant profit and the other a loss.

### **Interim Financing**

'Interim financing' refers to financing that covers the construction period up to 80% rent-up. It is important to analyze this issue, because the borrower must have sufficient financial strength to meet interim financing requirements.

The analyst assesses the project's interim financing requirements and makes recommendations regarding additional security beyond the real estate asset, such as mortgage guarantees and letters of credit. This is an important contribution.

**Part 2**

Continued

Analyzing a borrower's financial statements can be difficult in many instances, because the statements are often very complex. There are seldom classifications of current assets and current liabilities. The status of land or buildings under development is sometimes difficult to determine, and there are other wrinkles peculiar to the building and development industry, such as deferred taxes and appraisal surplus.

The financial analyst's comments on the Corporate Statement of Changes in Financial Position provide an insight into how the builder operates from a cash point of view. When this statement is prepared on a funds basis, dealing with the changes in working capital, only the funds generated by operations, and the sources and uses from non-current assets, will be displayed.

It is also important that cash flow projections for projects under construction be reviewed, including the project being underwritten if it is new construction. Generally, such projections must be requested from the builder.

***Deferred Taxes***

These taxes usually arise because companies record depreciation in accordance with generally accepted accounting methods, whereas for income tax purposes they can claim higher depreciation (capital cost allowances). In this way they can reduce their profits for income tax purposes below those reported in the financial statements. This results in lower current income taxes and defers a portion of income taxes to some future year.

As the name implies, these taxes are just deferred. The theory is that they will be paid at some time in the future when the recorded depreciation is more than the amount of capital cost allowance that could be claimed for income-tax purposes. The excess taxes would then be recorded against the deferred taxes, which would mean that a portion of the deferred taxes would have to be paid.

In some companies, especially those constantly increasing their portfolio, it will be many years before they will have to repay any of these taxes. It has been suggested that deferred taxes should be treated almost like shareholder's equity, since some people feel that the profits have been understated by the amount of the deferred taxes.

In some companies, there is a certain amount of validity to this argument. However, deferred taxes should not be considered as part of shareholder's equity in the normal course of analyzing financial statements. They may, however, merit serious consideration in some situations.

***Appraisal Surpluses***

Traditionally, the fixed assets are always shown on the balance sheet at cost. However, since the value of many properties may have increased over the years, some companies show the appraised value of their properties on the balance sheet, and an appraisal surplus in the shareholder's equity section of the balance sheet.

Normally, the auditor's opinion does not cover the absolute correctness of their appraisal treatment. However, the auditors do satisfy themselves that the methods used and the results obtained are reasonable. The appraisal treatment should be explained in the notes on the balance sheet.

Appraisal information contained in the balance sheet is normally accepted as valid since the financial statements so adjusted may give a truer picture of the company's financial position. However, the appraisal information must be related to the area in which the properties are located, to ensure that they are still reliable. Underwriters must satisfy themselves that the value estimates reported in either the financial statements or the borrower's net worth statement are reasonable.

**Credit Reports**

A credit report will be obtained by the financial analyst. This will be on the applicant or on the company that will be asked to guarantee the mortgage, such as the parent or substantial operating company, rather than a 'shell' company.

The credit report will show a variety of things about a company, such as:

- company name
- affiliated and subsidiary companies
- principal owners
- bankers
- senior management personnel
- volume of business in the previous year
- history of projects undertaken in the previous two to five years
- history of liens such as those by mechanics
- payment habits as reported by suppliers or sub-traders
- descriptive history of the company or owners, in the building business

Sometimes, especially if the company is small, new in the business or uncooperative about giving out information, these reports may not be very informative. These credit reports can be obtained for the principals of the company.

**Bank Reports**

The borrower should provide a letter from his bank relating the bank's experience with him, in particular:

- whether the developer has been a good customer
- for how many years
- what the operating lines of credit are
- what the average outstanding loan amounts in the past year were
- whether the borrower has paid as agreed.

**Net Worth Analysis**

The Calculation of Net Worth Matrix is a tool to analyze assets and liabilities based on their attributes of stability of value, liquidity and the ability to realize on them. There are four tiers, with each weighting the asset differently. For assets that fall within tier one, one hundred percent of their value may be included in the net worth calculation, for tier two, ninety percent, for tier three, fifty percent and for tier four, none.

The value of all assets must be substantiated to be included in a net worth calculation.

**Part 2**

Continued

**Calculation of Net Worth by Classification of Assets into Tiers**

TYPE OF ASSET/(LIABILITY)	Tier 1 100%	Tier 2 90%	Tier 3 50%	Tier 4 0%
<b>ASSETS:</b>				
Cash	X			
Marketable Securities	X			
RRSP's			X	
Personal Vehicles		X		
Personal Effects				X
Inventory	X			
Licenses		X		
Accounts/Notes Receivable - Arm's Length	X			
Accounts/Notes Receivable - Non Arm's Length	X	X	X	X
Arm's Length Mortgages - First		X		
Arm's Length Mortgages - Second and Beyond			X	
Non-Arm's Length Mortgages	X	X	X	X
Real Estate	X			
Vacant Land			X	
Bonds	X			
Precious Metals		X		
Net Non-Canadian Assets				X

**Investments in Private Companies  
and Partnerships:**

Sole ownership of private co. or proprietorship	X			
Shared ownership of private company		X		
Interest in general or limited partnership			X	
Appraisal Surpluses	X			
Deferred Charges				X
Deferred Taxes Debits				X
Goodwill				X

**(LIABILITIES:)**

Deferred Tax Credits				X
All Others	X			

The sum of the above values is CMHC's estimate of the proponent's net worth



## Part 3

# Analysis of the Security

A full assessment of the degree of security provided by the real estate requires this information:

- appraisal report
- report on the quality, condition and durability of the project
- environmental assessment.

### Appraisal Report

The purpose of the appraisal is to estimate the current market value of the property on the effective date of the appraisal, which is usually the date of inspection, but must be within 90 days of the application.

Market value is defined as the most probable selling price that the property is likely to realize on sale, considering current market conditions, financing conditions and most probable purchaser. Market value usually assumes an 'as is' condition. If significant repairs or renovations are proposed, an 'improved' value will also be assigned.

The appraisal report contains these elements:

- photograph and project identification
- factual information
- characteristics of the site and the location
- description of the property
- cost approach
- income approach
- direct comparison approach
- reconciliation and final estimate of value
- certification
- signature of the appraiser.

Additional considerations must be included when dealing with:

- condominium projects
- appraisal of properties on leasehold land.

### Photograph and Project Identification

For existing projects, there will be photographs of the front and rear as a minimum, along with the project's name, civic address, number of units and legal description.

### Factual Information

This information includes:

- purpose of the appraisal
- effective date of appraisal
- date of inspection
- limiting conditions
- land tenure
- the zoning, the degree of conformance and an explanation and valuation conditions for non-conforming use
- registered encumbrances affecting value
- sales history for the past three years
- highest and best use, or a detailed explanation if other than this
- assessment and property taxes, with a determination, based on review, of whether an appeal is warranted, summarized in letter of transmittal
- state of the market, including economic climate, market conditions and value trends.

### Local and Situational Characteristics

This includes:

- brief comments on the desirability of the property's neighbourhood
- site dimensions and characteristics
- suitability of the site for the proposed development
- any detrimental factors affecting value, including occurrence and date of an environmental assessment, with a copy of the report, or a synopsis of it.

### Property Description

Brief comments are made on the following:

- building type
- type of construction
- age of building (chronological and effective)
- breakdown of unit types and sizes
- project condition, including details on deferred maintenance

**Part 3**

Continued

- general level of maintenance and quality of construction
- amenities provided in the project
- laundry facilities provided, and whether owned or leased
- services included in the rent
- parking
- any unusual conditions or factors that affect value.

**Cost Approach**

This approach is optional, but for new construction, a building reproduction cost is required.

**Income Approach**

This approach to value is based on competitive rental rates that are achievable by the project, and assuming operating expenses that are consistent with typical practices of entrepreneurs. Any issues or concerns the appraiser feels may affect the continued viability of the project will be discussed and summarized in the letter of transmittal.

The analysis includes:

- review of the current and historical rents and vacancies, including the current rent role
- schedule of comparable properties, and the adjustment used to establish the market rentals used in the appraisal-valuation process
- the current project vacancy rate, including collection loss, and the rates for the past three years, including a discussion of the market-area levels, resulting in a stabilized vacancy level based on the interpretation of this data
- operating expense estimates organized by expense items, based on an analysis of the property's expense history and experience with other similar properties and market norms, and must be consistent with typical entrepreneurial practices
- capitalization rate development, based on an analysis of comparable market sales, or through the mortgage equity technique in situations with few comparable sales.

**Direct Comparison Approach**

This approach includes:

- schedule of market comparables
- adjustment chart, showing dollar plus and minus, adjustments and supporting analysis
- indicated units of comparison and value estimate.

**Additional considerations**

Additional information is required when dealing with condominiums or projects on leasehold land.

**Condominium Projects**

Multiple-unit projects that are registered with condominium or strata titles, or which have the potential for conversion, will be evaluated to determine whether the value of the project based on the sale of individual units is greater than the rental value.

The strategies to be considered are:

- sale of individual units over a projected marketing period
- sale of individual units to a single purchaser who will resell the units
- sale of the project on a rental basis.

The last may require the purchaser to make bona fide offers to buy out the remaining homeowners as one of the conditions of the sale. This requirement is reflected in the probable sale price estimate provided by the appraiser, but not in the market value estimate assuming typical marketing terms and conditions.

**Appraisal of Properties on Leasehold Land**

Market value estimates for properties on leasehold land are provided on a freehold as well as a leasehold basis. Where the amount of the option price to acquire the freehold interest is unknown, the appraiser will provide a separate estimate of the market value of the lessor's interest in the land.

## Report on Quality, Condition and Durability

To establish the suitability of the project for its intended use, an on-site review of all the major physical elements of the buildings and the site is usually required. The comprehensiveness of the review will vary with the age, past history and inherent risk represented by the particular building materials and systems used.

For new construction, the basic standard of quality is the provincial or territorial building code, or, in their absence, the current edition of the National Building Code of Canada. When a loan applicant appoints one or more inspection consultants, the applicant must provide the approved lender with a copy of a letter from each that summarizes their respective inspection responsibilities. Each consultant must be skilled in the section of the work to be inspected.

For existing buildings, quality is measured against provincial legislation and municipal by-laws. Engineering and building-science principles are the basis of all analyses that are not simply code-compliance issues.

The report on Project Quality, Condition and Durability consists of two parts:

- project condition and durability
- function and appearance.

### Project Condition and Durability

Inspection documents appropriate to underwriting multiple-unit residential projects include:

- physical condition assessment report
- general technical audit
- project deficiency report.

The physical condition assessment report is the least comprehensive review, and is often used to trigger a subsequent, more comprehensive review by technical experts. It does not necessarily require an extensive technical background to conduct. The analyst usually uses a checklist with a list of indicators to conduct the review. No measurements of cost estimates are made. Visible building elements are examined, and indicators of possible performance problems are noted.

The general technical audit is the most comprehensive level of review, and requires an extensive technical background. The project is assigned a general condition rating. Remedial measures are discussed for performance problems, and estimates for repair are provided. All visible major building elements are described, and their condition is rated. Destructive testing is usually avoided, but may be required in some cases.

The project deficiency report is similar to the general technical audit, except that only those building elements exhibiting poor performance are described in detail.

### Function and Appearance

This review is intended to ensure there is a match between the proposal and the intended users' expectations of adequate value for the current market and for the longer term.

The conditions are assessed in terms of local norms and the intended market. The underwriter will work closely with the appraiser in this assessment, and usually obtain the advice of a building professional. The professional will be asked for suggested improvements, along with the identification of problems, where possible.

Components include:

- unit size and layout
- circulation and service systems
- communal facilities
- exterior amenities
- scale and relationship to context
- adjacent nuisances such as industrial or other uses
- maintenance issues.



**Part 3**

Continued

**Environmental Assessment**

The collection of information about potential environmental problems is a critical component of any underwriting decision. CMHC's approach to environmental risk management is as follows:

- property types requiring an environmental site assessment
- what constitutes an acceptable environmental site assessment
- acceptable environmental site assessors
- acceptance of environmental site assessments
- requirements for phase II and phase III site assessments

**Property Types Requiring an Environmental Site Assessment**

All properties over six units require an environmental site assessment (ESA). Properties of six or fewer units require one only if the approved lender or CMHC is aware of obvious environmental hazards, or of factors that might indicate potential environmental problems, such as housing built on old landfill sites.

**An Acceptable Environmental Site Assessment**

As a minimum, a Phase I ESA must be completed by a qualified environmental site assessor. This is intended to estimate the likelihood that a property may be contaminated with hazardous substances.

Phase I ESAs must be carried out in accordance with the principles and procedures described in the Canadian Standards Association (CSA) document Z768, Phase I Environmental Site Assessment. Copies may be obtained from the CSA.

If the Phase I site assessment allows the consultant to conclude that there is no evidence of contamination in connection with the property, CMHC does not require further environmental investigation.

**Acceptable Environmental Site Assessors**

There is currently no mechanism in Canada for accrediting assessors. The CSA provides guidelines as to the skill requirements those providing site assessments should possess, outline in CSA Z768.

Environmental site assessors hired by the applicant should be able to document their background and expertise.

**Acceptance of Environmental Site Assessments**

The underwriter will make the final determination of the site's acceptability. This decision will be based on the Phase I ESA interpretation guidelines CSA Z768.

**Requirements for Phase II and Phase III Site Assessments**

In case where the assessor has concluded that there is evidence of contamination in connection with the subject property, there is a need to proceed to a Phase II site assessment.

The purpose of the Phase II site assessment is to confirm and delineate, or to demonstrate the absence of, contamination on a property identified through a Phase I ESA procedure.

Criteria as to what constitutes an acceptable Phase II ESA are outlined in Appendix A of the CSA publication, "Phase I Environmental Site Assessment - Z768-94."

Where a Phase II ESA confirms the presence of contamination, a remedial investigation, or Phase III ESA, must be completed. Criteria as to what constitutes an acceptable PHASE III ESA are outlined in the Appendix B of CSA Z768-94.

Where Phase II or Phase III ESAs are required, they must be forwarded to CMHC, as part of the approval process of the subject application. Phase II and III ESAs do not require the recommendation of the approved lender, as do Phase I ESAs.

The approved lender should be familiar with the following three reference documents pertaining to environmental site assessments:

- CSA Z768-94
- Phase I ESA Interpretation Guidelines
- CMHC Mortgage Loan Insurance Handbook - Section II 0607-01.



## Part 4

# Documentation Required to Support Underwriting Recommendation

The amount and detail of available support documentation will vary from project to project, as will the need for specific information, depending on the size and complexity of the deal being underwritten and the individual underwriter's background and experience. Underwriters will exercise judgement in this regard, but will need to rationalize any missing documentation.

This section contains:

- documentation on the property
- documentation on the borrower.

### Documentation on the Property

For existing properties, the following is needed:

- current appraisal, with an effective date within thirty days of the application date, completed by a AACI or a EA as described in this document
- income and operating expense statements of the project for the past three years, or the life of the project, whichever is less
- current rent rolls; where rent control is in place, verification that rents are legal
- a report on the structural integrity of the building, including parking garages if applicable, and the state of major systems if the project is ten years or older, to be completed by an engineer or similarly qualified person
- a copy of the offer of purchase, if applicable
- details of existing financing, if applicable
- a Phase I environmental assessment
- a proposed detailed list of work with cost estimates for renovations and repairs that are required.

For new construction, the following is needed:

- a full set of architectural drawings
- a current appraisal, with a value estimate assuming the project is completed and occupied on the date of appraisal
- for retirement homes, an analysis of the market
- a detailed estimate of income and operating expenses, with estimates normally supported by written quotes

- cash flow from the start of construction through to full rent-up or sale
- Phase I environmental assessment.

### Documentation on the Borrower

The documentation that is required includes:

- track record
- management ability
- capacity.

The track record should include:

- type of organization, i.e. sole proprietorship, limited company, partnership
- an organization chart identifying the key players, their responsibilities, reporting relationships and related companies if appropriate
- a listing of other projects owned, including type, number of units, location, income generated, current debt and current value
- an analysis of how the proposal under consideration fits into their overall operations and the benefits to be gained by it.

The management ability is judged by an outline of how the project will be managed, including resumes of the manager, if different from the borrower and not already known by the underwriter. If a fee manager is to be hired, a copy of the draft contract will be included along with the background and experience of the manager.

An outline of the management plan will be included, with:

- procedures for site management
- financial control systems
- monitoring of income
- monitoring of operating expenses
- replacement funding
- tenant selections
- personnel practices.

**Part 4**

## Continued

The documentation on capacity includes:

- identification of the covenantors or guarantors
- financial statements, preferably audited, for the past three years for all covenantors and guarantors, if applicable. In the case where these come from a parent company, they will be consolidated statements covering a similar period
- a listing of properties with appraisal surpluses, including address, type of property, outstanding encumbrances, appraised value and date of the appraisal
- personal net worth statements for all individuals providing a covenant or guarantee
- credit reports on companies or individuals, as applicable
- substantiation of the value of the assets
- a letter from the borrower's bank identifying the amount of the operating line available and the amount drawn down on it
- the amount and source of down payment, for transactions involving purchase; for new construction, the source and amount of the interim financing
- a cash flow analysis for the borrower, showing total income and total payments.

**Part 5****Underwriting Report**

CMHC has developed two standardized underwriting reports, one for projects needing more analysis and a second for standard projects. This chapter describes the standardized underwriting report for projects needing more analysis. It provides a sample of the short-form report used for standard projects.

The report for projects needing more analysis has three parts:

- key factors related to the application
- details related to the applications
- risk items associated with the market, the borrower or the security, with any trade-offs to mitigate the risk.

**Key Factors**

There are six key factors:

- recommendation
- policy exceptions
- special conditions
- history of project
- environmental concerns
- interest rate sensitivity.

The recommendation has no more than four or five lines. It includes:

- purpose of the loan
- location of the property
- number of units
- loan amount, with a statement of whether it includes the fee and premium.

Notes on the other key factors:

- any policy exceptions being recommended are identified and a rationale for the exceptions explained
- any special conditions are identified and a rationale provided for their use
- the history indicates why the borrower applied for insurance at this time, how the project was previously financed and a statement about the arrears history
- the report states that an acceptable Phase I Environmental Site Assessment (ESA) has been received, along with the appropriate lender recommendation; if the site involves a Phase II ESA or clean-up, confirmation will be provided that it is consistent with CSA guidelines
- regarding interest rate sensitivity, the report indicates at what interest rate a 1.0 DCR is achieved.

**Details Related to the Application**

The headings may vary at the discretion of the underwriter; the following are usual.

**Loan Details**

- loan amount
- lender
- interest rate
- term
- amortization
- fees and premiums.

**Borrower Details**

- name of borrower
- covenantors
- guarantors.

**Security Description**

- number of buildings
- number of storeys
- number of units
- age
- dwelling type.

## Part 5

Continued

### Estimates

Table for Rental Projects							
	Gross Income	Operating Expenditures \$	Net Income	Cap Rate	Market Value	LTV	DCR
CMHC							
Borrower							

Table for Condominiums			
	Land Value	Value – Market comparison approach	Value – Cost approach
CMHC			
Borrower			

### Risk Items and Trade-offs

The headings for this section are:

- market
- borrower
- security
- correlation.

#### Market

This section provides information on the historical, current and projected vacancy rate of the project relative to the vacancy rate in the market generally. If the project is addressing an unproved market niche, there will be comments on any considerations that will be taken into account.

The report also includes:

- a comparison of project rents with the average market rents
- comments on the future competition, especially if new construction is involved.

#### Borrower

This section is a comment on the borrower's track record in the development, ownership or management of these types of projects. If full personal and corporate guarantees are not available, reasons will be given. For projects where the borrower's net worth provides a significant level of comfort, the value of the assets and the amount of liabilities must be confirmed. Particular attention will be paid to cash flow requirements of all borrowers' debts, and comment made on the need to take additional security.

#### Security

There will be a comment providing details on the security estimates provided in the table included in the second part of the report. Where there is a difference between the estimates provided by the lender and the ones arrived at by the underwriter, the difference will be explained.

There is also a comment on the overall condition of the property. For projects that are ten years of age or older, the underwriter includes a comment on the state of the major systems and components, including the parking garage, roof and heating facility.



Items of deferred maintenance or significant capital improvements that are required now or in the near future will be identified, and how these have been taken into account in the structuring of the deal to mitigate risks, such as by the establishment of replacement reserves.

**Correlation**

In the correlation section, the underwriter will explain the reason for proceeding with the loan. All positive aspects of the deal will be mentioned, as well as all negative ones with an explanation about the measures being structured in the deal to mitigate their impact on the risk.

At the end of the report there is an approval page showing the name and signature of the underwriter recommending the approval of the mortgage insurance, and the approval authority's name.

The document outlining special conditions will be attached as an appendix to the underwriting report. If deemed relevant, reports from professionals will also be attached as appendices.

**Part 5**

Continued



Canada

**SHORT FORM UNDERWRITING REPORT****Recommendation for Insurance of**

Account No: \_\_\_\_\_

Purpose of Loan: \_\_\_\_\_

Loan amount: \_\_\_\_\_

Premium: \_\_\_\_\_

Rate: \_\_\_\_\_

Amount: \_\_\_\_\_

Total Insured Loan: \_\_\_\_\_

Lender: \_\_\_\_\_

Interest rate: \_\_\_\_\_

Term/Amortization: \_\_\_\_\_

Underwriting Centre: \_\_\_\_\_

Underwriter: \_\_\_\_\_

**1. Security Description**

Location: \_\_\_\_\_

Age: \_\_\_\_\_

Project Size: \_\_\_\_\_

Unit Breakdown: \_\_\_\_\_

Condition: \_\_\_\_\_

If project over 10 years old, has underground parking, or potential post tension concrete, was an inspection completed?

☐ Yes ☐ No If no, why? \_\_\_\_\_

Summary of Inspection Findings: \_\_\_\_\_

**2. Security Valuation**

Income Rate: \_\_\_\_\_

Internal Appraiser: \_\_\_\_\_

Borrower Estimates: \_\_\_\_\_

Estimates utilized by Underwriter : \_\_\_\_\_

Was formal appraisal  
review completed? Type:

Internal

☐ Yes☐ No

External

☐ Yes☐ No

Both

☐ Yes☐ No

If no, why not: \_\_\_\_\_

Was a formal market analysis review completed? ☐ Yes ☐ No If no, why not \_\_\_\_\_

Project Vacancy Rate: \_\_\_\_\_

Market Value Rate: \_\_\_\_\_

Rationale, if considerable variance \_\_\_\_\_

Was the actual capitalization rate utilized supported by market sales? ☐ Yes ☐ No

If no, how substantiated: \_\_\_\_\_

Were actual income statements of the project reviewed and used in the underwriter's estimates? ☐ Yes ☐ No

If no, explain why:

### 3. Borrower Considerations

This applicant has had past real estate experience ☐ Yes ☐ No

If yes, describe quality of past dealings and total current exposure of CMHC:

Net Worth:	Total Assets	
	Total Liabilities	
	Net Worth	

How were the current value of the assets and liabilities confirmed?

### 4. Interest Rate Sensitivity

(i) Subject Debt Coverage (at 9%):

At contract rate:

Mortgage rate to achieve 1.0 DCR:

(ii) Total Borrower DCR:

Describe how total income and expenses of borrower were verified for total DCR:

### 5. Environmental Considerations

An acceptable phase I environmental audit was received and included the recommendations of the Approved Lender. ☐ Yes ☐ No

If no, provide further comments satisfying this consideration:

### 6. Correlation

Highlight, from the above the rationale for approving, including the additional of special conditions where appropriate or declining this application.

**Note:** In order to qualify for the utilization of this Short Form Underwriting Report this application does not include any of the following categories:

- no care facilities
- no multi-project applications
- no projects requiring the approval of the MUC/complex projects
- market vacancy is no greater than 3% and/or (no one industry towns)
- no new construction

Underwritten by:

Approved by:









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### **Administrative Guide - Default Management and Claims**

5557E

### **Administrative Guide - Application Processing for Home Ownership Mortgage Loan Insurance**

5552E

### **Home Ownership Loans - Borrower Eligibility**

6480E

### **The CMHC Alternative for Multiples (Pamphlet)**

6693E

### **CMHC's Approach to Mortgage Underwriting for Residential Multiples**

6965E

### **Pocket Guide**

5582E

## For your customers

### **Mortgage Loan Insurance - Welcome Home**

6811E

### **The Complete Guide to Buying Your Home\***

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